ST 98-22
Tax Type: SALES TAX
Issue: Sales v. Resale Issues

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	
v.	No. IBT:
TAXPAYER,	Christine O'Donoghue Administrative Law Judge
Taxpayer	

RECOMMENDATION FOR DISPOSITION

Appearances: Mr. Marc Muchin, Special Assistant Attorney General for the Illinois Department of Revenue.

Synopsis:

This matter comes on for hearing pursuant to TAXPAYER's (hereinafter the "taxpayer") timely protest of a Notice of Tax Liability assessing Use Tax on taxpayer's purchases during the period of January 1, 1993 through December 31, 1995. Taxpayer is a video store which both rents and sells videotapes. The Department contends that the taxpayer is primarily in the business of renting videotapes and thus, as the user of these tapes, it should have paid use tax on its purchases. The taxpayer, however, argues that every videotape in its store was available for sale during the entire audit period, thus, it primarily sold videotapes and it properly charged tax

on its sales of videotapes to end users. At issue is whether the taxpayer was the user of the videotapes, and thus liable for use tax or whether the renting of the tapes constitutes an interim use under Section 105/2. After a review of the transcript and the evidence it is my recommendation that the Notice of Tax Liability be finalized in its entirety.

Findings of Fact:

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established by the introduction of the correction of return showing tax, penalty, and interest in the amount of $2,882.00 for the period of January 1, 1993 through December 31, 1995. Dept. Ex. No. 1.
2. TAXPAYER, a sole proprietorship, has been operated by JOHN DOE since March of 1992. Tr. p. 16.
3. Total video rentals for 1994 is $63,969.93. Total income from videotape sales is $5,597.78. Tr. p. 19. Total income from video rentals in 1995 was $60,955.95. Tr. p. 19. Total income from videotape sales for 1995 is $4,352.16. Tr. p. 19.
4. Taxpayer's Group Exhibit No. 1 reflects that the taxpayer' s yearly income from rentals is over 10 or 20 times more than the sales. Tr. p. 22.
5. Taxpayer rented his video tapes for approximately $2.50. Tr. p. 22.
6. Taxpayer paid approximately $70.00 for a tape. Tr. p. 22.
7. Taxpayer rented catalog title and video games. Tr. p. 23.
8. Taxpayer did not pay tax on his purchase of video tapes. Tr. p. 27; Taxpayer Ex. Nos. 2 & 3.
9. During the course of the audit, the auditor gave the taxpayer credit for tapes for the taxes remitted when the taxpayer sold a tape. Tr. 28.

10. The auditor subtracted the taxable sales from the total income reported for the video store on Scheduled C of the US1040 to obtain the rental income figures. This rental income figure was divided by the total income to obtain a percentage of video rental income versus total income . Tr. p. 32. The auditor calculated this percentage for all three years of the audit period and then averaged the three years. Tr. p. 33.

11. Taxpayer's average income from sales for the three years was 8%. Ninety-two percent of the taxpayer's income was from video rentals. Tr. p. 33.

Conclusions of Law:

Pursuant to audit, the Department of Revenue issued a Notice of Tax Liability assessing Use Tax on the taxpayer's purchase of video tapes for the period of January 1, 1993 through December 31, 1995. The Department maintains that the renting of these videotapes constitutes a "use" by the taxpayer; thereby obligating the taxpayer to pay use tax on the purchase of these tapes. According to Section 105/2 of the Use Tax Act:

> "Use" means the exercise by any person of any right or power over tangible personal property incident to the ownership of that property, except that it does not include the sale of such property in any form as tangible personal property in the regular course of business to the extent that such property is not first subjected to a use for which it was purchased, … . However, "use" does not mean the demonstration use or interim use of tangible personal property by a retailer before he sells that tangible personal property. …

35 **ILCS** 105/2.

Taxpayer is in the business of renting videotapes of movies and computer games to customers for entertainment. The taxpayer contends that its purchase of video tapes should not be subject to use tax, insofar as the rentals constitute an interim use. Since the renting of the

tapes constituted an interim use, the taxpayer maintains it properly charged tax; i.e., when any one of the video tapes was sold to a customer, it collected the use tax from the customer and properly remitted the retailers' occupation tax to the Department.

Taxpayer's position, however, is not supported by either Illinois statute or case law.

In Illinois, lessors are deemed to be the user of the items it purchases for rental purposes. Section 150.306 of the Department's regulations provides that:

> the leasing of tangible personal property by persons who are primarily engaged in the business of selling such property at retail is within the interim use exemption if such property is carried as inventory on the books of the retailer or is otherwise available for sale during the last period. The interim use exemption is not available to persons who purchase tangible personal property with the intent to engage in the business of leasing such property and who sell such property only as an incident to their leasing activity. …

86 Ill. Admin. Code 150.306

Furthermore, Section 130.2010 (b) provides:

> Persons Who Rent or Lease the Use of Tangible Personal Property to Others – When Not Liable for Retailers' Occupation Tax" - Persons who, under bona fide agreements, rent or lease the use of automobiles under lease terms of more than one year, furniture, bus tires, costumes, towels, linens or other tangible personal property to others are, to this extent, not engaged in the business of selling tangible personal property to purchasers for use or consumption within the meaning of the Retailers' Occupation Tax Act and are not required to remit Retailers' Occupation Tax measured by their gross receipts from such transactions. However, such lessors (not being resellers) are users of the property and are subject to the Use Tax when purchasing tangible personal property which they rent or lease to others … .

86 Ill. Admin. Code 130.2010(b).

As users, the lessor incurs a use tax liability on the cost price of the tangible personal property purchased for rental purposes and their rental receipts are not subject to sales tax

liability. If taxpayer were strictly a lessor and were merely selling videotapes which were no longer needed in the rental and did not engage in selling at retail, then that person incurs no ROT liability when selling items since these sales would constitute occasional sales under the statute. *See,*

The Department's regulations require that a taxpayer be *primarily* engaged in the business of selling such property at retail in order for its purchase to qualify under the interim use exemption. It also mandates that we look to the intent of the taxpayer at the time of purchase to determine whether the taxpayer's use constitutes an interim use. Therefore, it must be determined whether the taxpayer, at the time of purchase, intended to engage in leasing the product and the sale was only incidental.

To support its' contention that its rental activities constitute an interim use, the taxpayer cites Illinois Road Equipment Company v. Department of Revenue, 32 Ill. 2d 576. In Illinois Road Equipment, the Court held that the rental of heavy construction machinery by a retailer constituted an interim use, and as such held that the taxpayer was not liable for use tax on the purchase of this machinery but should charge retailers' occupation tax on the sale of these machines to consumers. Taxpayer argues that this case parallels the matter at hand; however, his reliance on this holding is misplaced in that the case is distinguishable from the facts in the present matter.

In Illinois Road Equipment, the taxpayer's principal business was the sale of new machines; it merely rented new and reconditioned machinery to prospective buyers for the purpose of allowing them to ascertain whether the machinery suited their particular needs. The court found that there was evidence that during the years involved the amount of rent received averaged less than one percent of plaintiff's annual gross income.

The court found that none of the machinery was held for any ultimate purpose other than retail sale, therefore the practice of renting on a promotional basis did not subject sellers to use tax liability. However, in the case at hand, the video tapes are bought and held for two ultimate purposes: 1) first, to garner income from the regular practice of renting to lessees and/or 2) to sell to consumers. Taxpayer's business substantially relied on its income from renting the videotapes, the records show that it could not possibly remain in business if it were to rely on income from sales alone. In fact, the taxpayer admitted that the realities of the marketplace dictated the rental of videotapes because consumers would not pay $80.00 or so for a video tape. Thus, at the time of purchase the taxpayer intended to both rent and sell the video.

During the course of the audit, the auditor determined the percentage of income derived from taxable sales as compared to the percentage of income derived from video rentals. The auditor derived the total income from the taxpayer's US1040, and determined the dollar figures for taxable sales and video rentals from the taxpayer's books and records for the entire audit period. For the three year period, video rentals accounted for an average of 92% of the taxpayer's gross income.

Taxpayer objects to the auditor's methodology because it maintains that the sales figures would necessarily be lower because a consumer will not buy a videotape for the taxpayer's purchase price. The tapes generally only sell for $10 or $12 after it has been rented for a period of time.

Pursuant to Illinois statute and case law, the correction of returns is *prima facie* correct and constitutes *prima facie* evidence of the correctness of the tax due. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968). The Department's determinations are rebutted only after a taxpayer introduces documentary evidence which is consistent, probable and identified with

taxpayer's books and records, showing that the Department's determination is incorrect. A. R. Barnes v. Department of Revenue, 173 Ill. App. 3d 826, 835 (1st Dist. 1988).

The question of whether an audit determination meets a minimum standard of reasonableness should not be posed until a taxpayer has introduced credible evidence that the tax adjustment proposed failed to meet these standards. The Department is not required to prove the reasonableness of its audit determinations before the statutory presumption of correctness attaches. Vitale v. Department of Revenue, 118 Ill. App. 3d 210 (3d Dist. 1983). It is the taxpayer's burden to prove that the auditor's error projections and its method of calculating the 1991 sales is clearly incorrect. Here, the taxpayer has only put forth the argument that the auditor's error projections *may* be wrong, however, a hypothetical does not rebut the *prima facie* correctness of the Department's determinations. Taxpayer has not reviewed the royalty reports in detail and produced a final and accurate figure which reflects the actual amount of error in the entire audit period, a number which would directly contradict the auditor's error projections and show the unreasonableness of the auditor's methods. Nor has the taxpayer proven that the auditor's method of calculating the 1991 sales is clearly unreasonable, it has only argued that its' own estimate is better. Case law in Illinois, however, clearly indicates that merely denying the accuracy of the Department's assessments, offering alternative procedures or arguing its audit methodology is flawed does not overcome the Department's *prima facie* case. A. R. Barnes & Co., *supra*; Mel-Park Drugs v. Dept. of Revenue, 218 Ill. App. 3d 203 (1st Dist. 1991).

The primary business of the taxpayer is the rental of videotapes, the rental receipts totaling over during the audit period, whereas, the gross receipts from the sales of videotapes were inconsequential as compared to the total receipts.

Wherefore, it is my recommendation that the Notice of Tax Liability be finalized in its entirety.

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Christine O'Donoghue
Administrative Law Judge